WESTWOOD CAPITAL, LLC

OPINION

October 7, 2009

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On the Future of Banking and Regulation:
Lessons We Should Have Learned

*Our essay below was first published online by **The New York Times** earlier today, as part of its Dealbook Dialogue roundtable discussion this week, debating how we arrived at the financial crisis and where we should go from here. Please do not hesitate to offer comment at the Times' link below.*[1]

With the conclusion of last weekend's G7 proceedings in Istanbul, and the G20 gathering last month, we offer our views on the realities we have faced—and those we have yet to confront—in relation to the banking system in the so-called developed world, following the Great Panic of 2008:

Let's Get Real

Banks in North America, Europe and Japan cannot be expected to awaken suddenly one Monday morning and decide to massively dilute their existing stockholders—thereby depressing the value of their shares (of which, presumably, managements own a fair share)—to build the equity they clearly need to:

(i) Absorb the lingering impact on bank assets' values caused by the bursting of the most widespread financial asset bubble in modern history;

(ii) Sufficiently cushion their operations in a manner that reasonably assures they do not pose meaningful systemic or depository insurance risks in the future; and

(iii) Resume fulfilling their principal function in the economy—that of capital formation and allocation.

The Stress Tests Were Insufficient

Accordingly, it is up to regulators and governments to impose upon the banking sector much more stringent capital requirements, and to demand such enhanced capitalization as soon as possible to further a real recovery. Additional capital will obviously enable faster resolution of existing toxic assets, to say nothing of fostering new lending. Some would argue that this was the purpose of the stress tests and that

[1] http://dealbook.blogs.nytimes.com/2009/10/07/banking-lessons-we-should-have-learned/

we've already completed that task. In our view, the stress tests left the banks (and their shareholders) with options that were inappropriate to the circumstances and therefore the tests were insufficient.

The most disturbing option left to the banks (without regard to whether stress-tested estimates of losses and future earnings were realistic in and of themselves) is to “roll the hoop” (or “kick the can down the road”; choose your favorite metaphor) in the hope they can earn extraordinary profits, enjoy a more robust recovery of asset value than can be reasonably expected, and/or be the beneficiaries of some future miracle. Given the importance of banks to the broader economy, “rolling” and “kicking” are not viable options. But the management and shareholders of any bank would be insane to part with such options voluntarily.

Banking is a Government Granted Privilege

Banking is a franchise granted by government charter. The existence of government-backed deposit insurance makes this charter extremely valuable to recipients thereof and something on the order of a sacred trust between citizens/taxpayers and banks. Banking regulators and governments (and society at large) owe no particular duty to banks’ shareholders, other than respect for their property rights and fair, equitable treatment. The same holds true for banks’ creditors. Regulators must avoid becoming co-opted by the institutions they regulate. This requires them to place the interests of the economy at large above those of any institution or its shareholders.

Management will always resist expanding a bank’s capital base through anything other than retained earnings after a generous dividend (or the occasional issuance of shares during times when they believe their shares are significantly overvalued); it is in bank management’s and shareholders’ distinct interest to do so. Regulators, of course, want to avoid frightening off potential investors in the banking sector. But the unfortunate truth is that if bank capital is insufficiently large to absorb significant stress, no prudent private investors will offer their help when risk is high and capital is most needed.

Some will Win, Others will Lose –
But Increased Capital Requirements will Unclog the Industry

Some observers may (not incorrectly) point out that, despite some degree of recovery, certain, arguably systemically critical institutions simply cannot currently raise sufficient private capital to eliminate the true risks they pose to the financial system. After all, even today, the magnitude of potential losses to many institutional balance sheets is still too great—and, to an extent, unknowable

Asset sales to raise capital may not be an option, given that many bank assets, held in excess of market value, are still on the books. While large banks severely wrote down interests in securities they held (and may even experience some helpful “write-ups” during the quarter just ended), the overwhelming majority of banks’ higher risk assets are held in “whole loan” form and are not required to be marked to market.

Requiring banks to increase capital substantially will—assuming investors of equity capital are rational and wish to avoid future dilution—require banks to make greater provisions for troubled assets. This would allow their sale or another resolution sooner than would otherwise occur. And, yes, banks that cannot meet increased capital requirements for lack of investor interest must be taken over by stronger competitors or placed into receivership.

Government Did What it Needed to at the Peak of the Crisis – But it is Time to Take the Next Step

Government recapitalization of systemically critical institutions during the peak of the crisis avoided the need to take a slice out of creditors' interests (out of a, frankly realistic, concern that burning down the interests of bank creditors would have an adverse ripple effect throughout the capital markets). We would argue that we are past the point of panic and that it is now time to take the necessary steps to recapitalize the most sickly of institutions on the backs of any of their stakeholders (owners and/or creditors), where this needs to occur.

On a smaller scale, this is already happening across the street from our own offices in Manhattan—at CIT's headquarters—the direct result of the FDIC saying "no" to a bailout. CIT management is doing what has become necessary because it lacks the optionality implicit in the notion of "too big to fail." This must become the rule, not the exception, for even our largest institutions.

We must protect ourselves by requiring more conservative equity capitalization. To do otherwise as a society would be our own folly.

Not "Too-Big-to-Fail"

As much as the "put to government," in the form of the too-big-to-fail notion, must be eradicated, a related concept—one we call "no-need-to-fail"—has legitimacy in regulatory and economic thought. There will always be opportunities for bank panics—not by insured depositors, but by creditors and other counterparties that trade daily with banks. Surely, a less leveraged banking system would make asset bubbles—and the resulting crashes that give rise to such panics—less likely. But it is impossible to completely eradicate the potential for creditor-led bank runs, without eliminating banks' ability to take any meaningful form of risk in the process.

In 2008, and early this year, policy makers—in their most lucid moments—realized that banks with otherwise healthy (or, at least, not entirely devastated) balance sheets would be tarred with the same brush as those with one foot in the grave. As with the events that spurred Franklin Roosevelt's decision to close all U.S. banks for a four-day breather in 1932, regulators worldwide recognized there was no need to subject the entire global banking system—and the broader economy—to an asset grab that would have harpooned the relatively strong, along with the weak.

Government intervention to avoid a similar result is legitimate. The notion of any individual institution being too big to fail, however, is a false precept. Regulators' claims (however real) that the scope of their oversight and authority may prohibit them from seizing and resolving any element of a banking institution are anathema and is a situation that cannot be tolerated. And, activities that place the banking system at risk of a major crisis caused by unregulated financial entities—the "shadow banking system"—must be monitored and curtailed.

This is Not a Time for Complacency

There will always be a degree of volatility in the value of bank assets; it is the corollary of risk-taking, without which effective capital formation and allocation cannot occur. Likewise, there will always be bank failures. But the system as a whole—by individual institutions on the equity side of their balance sheets, and collectively among institutions through adequate assessments supporting deposit insurance—must be sufficiently capitalized to absorb losses on troubled assets without shutting down banks' ability to continue lending and otherwise fulfilling the mission society has chartered them to execute, even in the context of an interim crisis.

Placed in a British context, re-regulating the banking system our global regulatory team has taken the match only halfway (if that) down the pitch, whereupon governments seem to have sat down with the ball and ordered tea. We are still far from the goal and have recently shown little evidence of an ability to score.

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